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SIPDIS

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SENSITIVE

DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS
COMMERCE FOR 4430/GOLIKE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR FINEMAN
DEPARTMENT PASS EXIM BANK

E.O. 12598: N/A

TAGS: [EFIN](#) [EINV](#) [ECON](#) [PGOV](#) [KCOR](#) [ID](#)

SUBJECT: INDONESIA'S ECONOMY - RIGHT DIRECTION, WRONG SPEED
- VISIT OF TREASURY OFFICIALS BAUKOL AND SEARLS

Ref: A) Jakarta 5704 (Labor); B) Jakarta 10539 (Newmont);

C) Jakarta 11110 (Mudflow); D) Jakarta 9864 (Biofuels);
E) Jakarta 9336 (Infrastructure); F) Jakarta 1833 (Banking
Sector)

¶1. Summary. Private sector and Government of Indonesia (GOI) interlocutors expressed optimism about the financial sector's growth and progress, but concern about the real sector, during the September 13-15 visit of Department of Treasury officials Andrew Baukol and Seth Searls. Most agreed Indonesia's economy needs more growth and investment and that GOI spending is slow in part due to inefficient local spending and fears by project managers that they may face corruption charges. The investment climate remains very challenging for western firms, so Indonesia will probably be a market mainly for Asian investors for a long time. In this environment, capital markets, rather than long-term investment, are receiving the bulk of overseas investor interest. Infrastructure development is still lagging, but the Asian Development Bank (ADB) is helping the GOI develop a few credible infrastructure projects for tender in time for a November 1-3 infrastructure conference in Jakarta. The rest of the banking sector is growing and relatively healthy. A new GOI regulation on the restructuring of non-performing loans (NPLs) may help Bank Mandiri and BNI, the two largest state-owned banks, clean up their balance books. Bank Indonesia (BI) Senior Deputy Governor Miranda Goeltum said she worries that recent strong capital market inflows are a sign that expectations are a bit too high, but others in the private sector view this dynamism as a positive sign. End Summary.

Macroeconomy - Good but Could Be Better

¶2. (SBU) During three days of meetings with GOI officials and private sector contacts September 13-15, visiting Department of Treasury officials Andrew Baukol and Seth Searls heard that Indonesia's macro-economy is stable but needs stronger growth. A prominent expat consultant noted that his most recent presentation on Indonesia's economy and investment climate is called, "Right Direction, Wrong Speed." Investment bankers we spoke with agreed that

Indonesia has a good economic team and reasonable growth, but needs more and that longer-term foreign direct investment (FDI) is not coming in fast enough. A ratings agency representative sounded a similar theme, telling us that he would like to see Indonesia have more exports, investment and a more stable currency. Senior Bank Indonesia (BI) Deputy Governor Miranda Goeltum also agreed with this conclusion, stating that Indonesia has made great progress compared with the past, but that it is still lagging behind in the region. One positive aspect is that inflationary pressures have been more subdued than in previous episodes when the GOI raised administered prices. Consumers reacted calmly, and the October 2005 fuel price hikes did not cause excessive increases in the prices of other staples or lead to the stockpiling of goods. Thus BI was able to bring inflation expectations down in six months. Goeltum said she expects inflation will fall to 6.5% on a year-on-year basis by the end of the year.

Anti-Corruption Efforts Slow GOI Spending

¶3. (BU) Several contacts told us that GOI spending is low because project leaders responsible for implementing projects at the sub-national level are afraid to do their jobs for fear of corruption accusations. One Indonesian

economist and advisor to the GOI told us that many project managers have resigned, and those remaining are not spending the money. One private sector contact suggested that the incentives need to be changed, perhaps by offering a "transparent bonus" for good project implementation. Other observers note that provincial governments simply lack a clear mandate as well as the capacity to budget and monitor spending. Several donors, including USAID and the World

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Bank, are helping Indonesia with local government capacity building.

Investment Climate - FDI Needed

¶4. (SBU) One prominent expat consultant noted that Indonesia still has a "socialist ethos" which is suspicious of foreign direct investment (FDI). In a climate which requires significant incentives to compete regionally, this system remains an impediment to Indonesia's competitiveness. The international business chambers and the Indonesian Chamber of Commerce and Industry (KADIN) are quite frustrated that President Susilo Bambang Yudhoyono (SBY) has not been able to deliver on promises to improve the investment climate. The consultant noted that given all the investment climate challenges here, Indonesia will probably remain a destination for mainly Asian investors for a long time. Inflexible labor regulations are stifling investment, and planned GOI changes to the labor law have been held up for some time. Our consultant contact opined that, "If labor reform doesn't happen soon, it won't happen." The window is closing for progress since the elections in 2009 will play an increasingly complicating role. The investment law has been in Parliament since late March and may pass by early ¶2007.

¶5. (SBU) BI officials told us another constraint on investment is poor infrastructure: companies do not have any certainty that what they need to be successful will be available or reliable, including roads, water, electricity, human capital, and property rights. Dr. M. Chatib Basri, Director of the Institute of Economic and Social Research concurred, noting that while many analysts have focused on inflexible hiring and firing practices, logistics represent 14% of production costs while labor is only 7%. Factors that raise costs include inefficient roads, "irregular" trucking and customs fees, and congested ports. On the positive side, tax reforms are beginning to produce results.

In special tax offices set up for medium-sized companies, VAT collection is up 80% as a result of new information technology systems. Customs reform, however, remains sluggish.

16. (SBU) Several international business contacts noted the dramatic contrast between the Environment Ministry's harsh handling of the international mining company Newmont in the Buyat Base case and the lenient treatment afforded the Indonesian firm Lapindo in the Sidoarjo mudflow disaster. The Environment Ministry initially condemned the company, but backed off a few days later, a fact likely due to Lapindo's connection with Coordinating Minister for Peoples' Welfare Aburizal Bakrie. The Environment Minister has even made public comments downplaying the environmental and health effects of the mud and its noxious, sulfurous gases, and no one involved has yet been charged with any crime. One expat consultant remarked, "I'm surprised the international media has not publicized this story. It's a huge environmental disaster."

Infrastructure - Credible Projects by November?

17. (SBU) Several contacts noted Indonesia has had difficulty in reviving its real sector. BI officials told us that many of the large Indonesian companies that could be players in infrastructure development have a corrupt history and are therefore unappealing to potential foreign partners. In order to move forward, Indonesia needs to establish a good model for public-private partnerships. ADB officials, who have been advising the GOI on infrastructure issues, said the ADB and GOI are selecting a short list of 6-8 projects, and hoped to have 2-3 ready for a credible tender by the November 1-3 Infrastructure Conference November 1-3 (Ref E). Another ADB official said that, "If Indonesia can showcase even one, non-corrupt, bankable, credibly implemented infrastructure tender and project, it will make a huge

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positive impact." ADB officials also said that the debate about corruption in Jakarta's monorail project is "exactly what is supposed to happen. Expectations are higher for greater transparency now."

Biofuels - Right Goals, Wrong Concept?

18. (SBU) Dr. M. Chatib Basri, Director of the Institute of Economic and Social Research and informal economic advisor to SBY, gave us some insight into the thinking behind SBY's biofuel initiative (reftel D). Basri said that the President specifically had Roosevelt's "New Deal" in mind and asked Basri to find him a good book about it. The President has been growing impatient with the lack of progress on reducing unemployment. He has in mind three initiatives to generate new jobs, especially to achieve results before the 2009 election.

- a "cash for work" program for the unemployed;
- better facilitation of overseas worker remittances;
- a biofuel initiative to generate 3.5 million jobs.

19. (SBU) However, Basri said he was concerned about underlying economics of SBY's biofuel initiative since Crude Palm Oil (CPO) production requires a huge amount of land and too much lead time to get results quickly. Land issues in Indonesia are always very difficult because a patchwork of different property rights and land use practices, laws and regulations prevail in different areas. The plantation sector is "hot" right now, Basri noted, and prices of some good land have already inflated to US \$6,000 per hectare. Political parties are already interfering. An international investment bank also noted that CPO, the primary ingredient in the biodiesel, costs Rp 3,500 (US \$0.40) per kilogram to purchase and Rp 1,500 (US \$0.17) to process into biofuel.

By comparison, subsidized diesel fuel sells for Rp 4,300/liter (US\$ 0.45).

¶10. (SBU) Basri added that with state-owned energy company Pertamina serving as the sole buyer, it is not clear how the program can be profitable. As a job creation program, the biofuel initiative will probably not be either effective or sustainable. Basri said he is recommending that a cash-for-work program would bring better results. He suggests that a rural infrastructure development program - already part of the GOI's priorities - would achieve both goals of creating jobs and improving rural economies.

Policy Packages - Getting Results?

¶11. (SBU) We asked our contacts what they thought about the new financial sector reform package. An international economist noted that part of the reason for these packages is to impose a "new form of coordination" on the ministries. Coordinating Minister Boediono, for example, has 16 line ministries under him from Finance to Fisheries headed by Ministers from several different political parties. The packages, with responsible ministries and deadlines clearly stated, create some measure of discipline. Currently, it is difficult to get ministries to do what they are not already planning to do themselves, the economist commented.

¶12. (SBU) The new package also addresses the non-bank financial sector. Some of Indonesia's small domestic insurers are in poor financial condition and the insurance sector has not been closely regulated in the past. However, on August 31, the Financial Institution and Capital Markets Supervisory Board (BAPEPAM-LK) BAPEPAM-LK issued a decree on insolvent insurance companies. The decree outlines the government's strategy for managing insolvent insurance and reinsurance companies. Our Coordinating Ministry contact said the Directorate of Insurance under MOF is already looking at the books of many small insurance companies. They will not become efficient on their own, our contact noted, "we must force them to grow up." Insolvent companies

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will have to restructure or close.

Banking Sector - Healthy Except Those Big State-Owned Banks

¶13. (SBU) Private bankers told us that last year's fuel price hikes and subsequent inflation are still hurting the buying power of consumers. Consumers were hit three times, one banker noted, with fuel prices going up, prices for staples rising in response, and interest rates increasing as well for consumer loans. Car and motorcycle sales are beginning to creep up again, he noted, but mortgages remain soft. The overall non-performing loan ratio is about 8% but without state-owned banks Mandiri and BNI it would only be 4.8% (Ref F). A private commercial banker told us that it is relatively easy for private banks to restructure bad loans, but state-owned banks have strict rules and limited options. Under current regulations, state-owned banks must obtain approval from the Minister of Finance before taking a haircut on loans up to US \$1 million. For loans up to US \$10 million, banks must get the approval of both the Minister of Finance and the President, and for loans above this amount Parliament must approve as well. By relaxing these rules a new Presidential Instruction under the financial sector package should help the state-owned banks clean up their books.

¶14. (SBU) Private commercial bankers at large domestic banks told us that their business is expanding. Representatives from two large private banks, Bank Central Asia (BCA) and Bank Danamon, said they continue to expand their business and the number of branches. BCA has 773 branches: it added

29 new ones in 2005 and will add another 27 by the end of 2006. Bank Danamon said that a recent banking services demographics study showed that the 60,000 wealthiest households in Indonesia keep most of their assets overseas. Most banks focus on the next wealthiest sector of the market consisting of about 6 million households: they try to sell them car loans, credit cards, mortgages, etc. and this segment has become very competitive. However, the largest (by population) sector of the market consists of 50 million households largely categorized as "self-employed mass market." Bank BRI, a state-owned bank and one of the largest micro-lenders in the world, services about 30% of this market. Danamon has also been setting up small marketplace branches to offer four simple loan products and four simple savings products to this sector and has been very successful. It opened its first small "marketplace" branch in July 2004 and now has over 800.

15. (U) BI officials told us that its new credit bureau is working fairly well. Due to a lack of unique identifier however, three parameters were required to search a borrower: name, address and date of birth. BI has been discussing a unique taxpayer identification number with the GOI.

Capital Markets Growing

16. (SBU) Capital markets are receiving the bulk of overseas investor interest in Indonesia. The Ministry of Finance noted that foreign ownership of rupiah-denominated bonds has more than doubled from 6% of total in September 2005 to 14% in August 2006. The main owners of domestic bonds, however, remain domestic banks at 55%. Indonesia is still designing a primary dealers market for GOI bonds. It is not yet clear if or when the GOI would offer Treasury bills with shorter maturities since "these could present another challenge for debt management," MOF officials told us.

17. (SBU) The Jakarta Stock Exchange (JSX) has also received a great deal of investment from overseas and domestic buyers. However, the JSX is still relatively thin, with only 336 listed companies valued at about US \$88 billion. As a result, large portfolio flows from overseas can create

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big swings. The Jakarta Composite Index (JCI) has risen from 750 in mid-2004 (before President SBY was elected) to over 1,400 in August 2006. Senior BI Deputy Governor Miranda Goeltum said she worries that these historic highs could mean a bubble. "The markets may be expecting more than we can fulfill," she noted. So much foreign exchange is coming into the capital markets that BI has to sterilize some of the inflows to smooth out the appreciation of the currency. "If the rupiah gets too strong, exporters can't compete," she said. Others in the private sector were encouraged by the dynamism in the capital markets, "We will have a very interesting couple of years ahead of us in Indonesia," one analyst told us.

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